USAID IMPACT ON COSTA RICA'S DEVELOPMENT DURING THE LAST 50 YEARS

Macroeconomic Policy and
Structural Adjustment

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Abstract

This chapter analyses the nature of the macroeconomic policy followed by Costa Rica during the period 1946-1994 It shows the expansion of the public sector that began in the early 1950s, the adoption of the import-substitution model when it joined the CACM and the improper fiscal and monetary/exchange policies followed during the 1970s In the early 1980s Costa Rica suffered one of its most severe economic crisis of the last 50 years

During the above-mentioned period USAID gave assistance to the country, with different intensity at first to finance *projects* and, after the debt crisis of the early 1980s, its help was conditioned to the adoption of *structural reforms* to foster sustained and shared growth USAID's financial assistance during the difficult period of adjustment helped the country maintain its purchasing power, employment and production levels and, thus, reduced the cost of adjusting and helped preserve Costa Rica's democratic system

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Macroeconomic Policy and Structural Adjustment

1 Introduction

Costa Rica's economy experienced significant structural transformations over the last fifty years It changed from an agricultural one, with two main export products (coffee and bananas) dominating the scene, to a more diversified industrial economy During the sixties, the diversification was stimulated by Costa Rica's joining the Central American Common Market (CACM) and by the adoption of its strategy of regional import substitution More recently, non-traditional exports to non-CACM countries has contributed to increased diversification Over the period 1946-1994 the relative size and role of the State changed significantly Thus, while in 1950 the public sector employment amounted to 6% of Costa Rica's labor force, by 1985 the proportion was 20% and the government, which was relatively passive in the late 40s and early 50s, became increasingly involved in the economic process--both through regulation as well as by direct participation in the production of goods and services

Social indicators improved throughout the period In 1950 life expectancy at birth was 59 yrs but by 1990 it was 76 yrs Achievements in general education are also notorious Income inequality has remained moderate and political stability strong in spite of the external shocks that affected the economy during that period (see Gonzalez-Vega, C and V H Cespedes 1993) The development process from 1950 to present has not been smooth--on the contrary, significant changes have taken place in the basic rules of the socio-economic game ("model"), which are analyzed in this chapter

Section 2 explains the logic behind macroeconomic adjustments (both of a stabilization and structural nature) and highlights the characteristics of the policy mix chosen by Costa Rica during the period, which led to the structural transformations that took place from the late 1940 s, when US financial and technical assistance through AID s predecessors began to manifest, to the present Section 3 presents the general nature of USAID s cooperation with Costa Rica during the last fifty years, its rationale during the different periods and circumstances and the conditionality that accompanied it

Section 4 evaluates the relevance of the main projects and programs undertaken by USAID in Costa Rica over that period and analyses how they favored, opposed or delayed the adoption of the main policies that led to the structural transformations that the new environment called for The section also presents the main lessons learned and make some recommendations of political importance on this respect

2 The Changing Nature of Macroeconomic Policy 1946-1994

Countries cannot spend more than they produce unless they are willing to loose international reserves or increase their foreign indebtedness A country s total expenditure also known as *absorption* consists of the sum of consumption and investment, both public and private In general when absorption exceeds the country's gross domestic product

(GDP) the excess reflects in a current account deficit, which has to be financed by capital inflows or by a loss of reserves

Countries may face macroeconomic desequilibria (e g , absorption exceeds GDP) due to unfavorable events outside their control, such as floods and droughts which reduce their production levels or deteriorate their international terms of trade However, most of the desequilibria faced by developing countries obey to causes that in principle can be controlled by their authorities high fiscal deficits relative to GDP which crowds out private financing, repressive financial practices, expansionary monetary policies or overvaluation of their currency, which translate into capital flights and unbearable current account deficits, to mention but a few adverse effects Said disbalances can be of a temporary nature in which case the authorities may choose to *finance* them, or long lasting, which call for macroeconomic *adjustment* The purpose of the macroeconomic policies in the latter case is not necessarily to eliminate the country's current account deficits, but to bring them down the levels consistent with the normal, sustainable, expected capital inflows (see Atta Mills, C and R Nallary, 1992)

The horizon for macroeconomic adjustments can be short or long term Short term (e g 18 month) programs, also known as *stabilization programs* take the GDP level as given and rely heavily on actions to control absorption, so that it coincides with the availability of external financing The purpose of (longer term) adjustment programs, also known as *structural adjustment programs* is both to control absorption and to expand production

Stabilization programs act upon the different components of absorption i e consumption and investment, both public and private Typical actions on this respect are the ones aimed at reducing the fiscal deficits (e g , revenue increase and expense reduction) and measures to control undue monetary expansions which, indirectly, act upon the current account balance through imports of goods and services The above actions are collectively known as *expenditure reducing* However, authorities may also want to adopt *expenditure switching* policies (such as real exchange devaluation or increases in tariffs) which influence the current account by stimulating local production at the expense of imports Devaluations compatible with the inflation differentials, between the adjusting country and its main trading partners, constitute accepted mechanisms to curb current account disbalances, but higher tariffs are not, because they interfere with international trade and thus reduce global output and welfare in the medium and long term

The International Monetary Fund (IMF) is, from the financial and technical point of view the leading multilateral agency dedicated to assist developing countries in their stabilization efforts

Structural adjustment programs aim at increasing the country's *productivity* (i e , to obtain more output from a given stock of resources) and at enhancing *capital formation* Measures directed at the removal of distortions, in areas such as international trade, the financial system and the public sector, and at the creation of a favorable environment for private investment are common components of structural adjustment programs When structural adjustment programs involve significant tariff reductions, which put pressure upon reserves they are commonly accompanied by structural adjustment loans (SALs) from multilateral agencies, to help the adjusting country bridge the gap between demand and supply of foreign exchange without having to recourse to large devaluations

The general approach adopted by Costa Rica to balance aggregate demand (absorption) with supply (GDP) and external financing, has varied over the last fifty years During the first half of the period the public sector finances were reasonable balanced and the occasional negative swings in current account brought by changes in its terms of trade were dealt directly--with dual exchange regimes and import controls As from the end of 1970s, fiscal disbalances and external shocks became more acute and the corresponding adjustment tended to rely more on indirect expenditure reducing and expenditure switching measures

The following paragraphs analyze the main periods of Costa Rica's recent economic history They present the general nature of the internal and external changes, how they affected the most important macroeconomic variables and the policies adopted by the authorities

2 1 <u>Public Sector Expansion 1950-1961</u>

In the 1940s important reforms took place in Costa Rica In the early 40s an advanced social security scheme was adopted, higher education was stimulated by the creation of Universidad de Costa Rica Commercial banking was nationalized in 1948 and a new constitution, which entrusted important new functions to the State, was adopted in 1949

In 1950 Costa Rica was a rural open economy that depended heavily on two export crops banana and coffee, which together accounted for 97% of the export revenues The balance of trade showed a surplus equivalent to 6% of GDP in 1950 because imports were not very high The country's population was only 858 200 in 1950 but its growth was high (3 4% per year) Costa Rica s per capita GDP amounted to about US$250--which may seem low but was higher, and more evenly distributed, than that of other Central American countries The main economic sector was agriculture, which accounted for 41% of GDP and 55% of the employment (*vs* 13% of GDP and 11% of employment contributed by manufacturing)

The public sector consisted basically of the Central Government, whose revenues amounted to 9 5% of GDP and even so managed to operate with a small surplus The objective of the government in the early 50s was to operate with fiscal balance and a stable currency Public servants constituted only 6% of the labor force, the private sector was by far the largest employer, and the economy basically operated under full employment

The growth of the economy during the 1950s was positive but highly variable Over the period 1950-59 the real GDP grew by 64%, but there were years (1955 and 1956) when growth was negative Due to the high population growth, the per capita income only increased by 19% during that decade During the period 1950-60 the average annual inflation rate was -0 5% and, consequently, the exchange rate remained unchanged (at the level CR ¢5 60 = US$1) throughout the period

A (short lived) civil war in 1948 brought to the political arena a new group of middle class social-democratic leaders which favor State *dirigisme* This group, which later constituted the highly influential Partido Liberacion Nacional (PLN), nationalized the banking system in 1948 and began to expand the role of the State through the creation of decentralized ('autonomous') institutions which soon became large employers This active role of the State was in a way, welcomed because the high population growth translated into high demand for social services, such as education, health and infrastructure and pressed for more employment opportunities (At the international level a similar movement took place The Charter of Punta del Este, signed in Uruguay in August, 1961 aimed at increasing the rate of economic growth in every country of Latin America by not less than 2 5 percent per capita per year and to make the benefits of economic progress available to all citizens of all economic and social groups To this end participating countries agreed to introduce national programs for economic and social development) Many autonomous institutions (e g , ICE, INVU, ICT) were created in Costa Rica during the 1950 s

Towards the end of the decade, the international price of coffee began to fall to very low levels, the terms of trade deteriorated and the trade account deteriorated sharply (c f , Vargas T R and O Saenz, 1994) The need to diversify the economy, at almost any cost began to gain political importance

Forced industrialization through protective barriers and other measures, had been recommended by the influential United Nations Economic Commission for Latin America (ECLA) , under Raul Prebish leadership, since the early 50s The adoption by Guatemala and El Salvador of specific legislation to favor industrialization and the signing, in 1958, of the Multilateral Treaty on Free Trade and Central American Economic Integration suggested that the adoption a new economic model was not too distant

2 2 Protectionism 1961-1972

In 1963 Costa Rica ratified the Multilateral Treaty and, under pressure from the Kennedy Administration in November of that year formally joined the CACM and adopted the instruments of integration which promoted a strategy of import substitution at the regional level The rules implied free trade among the Central American partner countries and protective barriers from all other regions, which created an *anti*-export bias to the extent that sales to the CACM were much more profitable than those directed to extra-CACM markets Income tax benefits and soft credit to the industrialists completed the scheme

Exports of manufactured goods, which in 1963 constituted a mere 4% of total exports grew to 28% in 1977 and most of them were exports to other CACM countries

By 1963 Costa Rica s population was 60% higher than in 1950 and real GDP per capita had increased by 22% The share of agriculture in GDP, as well as in employment had declined to 25% and 50% respectively The share of the public sector in both GDP and especially in employment increased significantly While employment in the private sector increased less than 1 3 times over the period 1950-63, public sector employment trebled

Both Central Government revenue and expense grew (in terms of GDP) between 1950 and 1963 However expenses grew faster than revenue The importance of the decentralized portion of the public sector also began to grow during the period

In the first half of the 1960 s large public sector expenditures (in power generation, telecommunications and, especially, transportation) helped the economy maintain adequate growth rates Gross domestic investment increased from 19% of GDP in 1960 to 26% in 1972 of this one third corresponded to the public sector Private investment in the first half of the sixties corresponded mostly to industrial expansion incentivated by the CACM, while during the second half the expansion of banana programs explains most of the increase in private investment

During the period 1950-1963 Costa Rica's imports of goods increased 170%, while exports grew by a mere 70% The combined effect of this was a trade deficit of 6% of GDP (compared to a 6% surplus in 1950) The share of coffee and bananas in export revenue fell to 72% (from 97% in 1950)

Costa Rica's investment and growth achievements during this period were accompanied by serious fiscal and balance of payments' difficulties, because internal savings did not compensate for the level of aggregate demand (*absorption*) Thus, the country had to depend on foreign savings to a significant degree In 1971, when a record was reached on this respect, foreign savings financed 43% of Costa Rica's investment During the decade the government was responsible for most of the savings-investment gap

Various factors explain the inadequate public saving performance First, the commitment of the government to provide physical infrastructure as well as a rising level of public services to a population that grew very fast Second, the tax base was severely undermined by the fiscal incentives granted under the CACM scheme Third, the prices of goods and services supplied by State-owned enterprises (SOEs) did not always reflect the full cost of their production

Other factors, besides the low levels of internal savings, explain the balance of payments difficulties The excessive dependence on exports of agricultural products, whose prices are subject to violent fluctuations, constrain the capacity to import and the above-mentioned pattern of industrial development, based on imported inputs, increased the rigidity of Costa Rica s balance of trade

The share of manufactures grew to 19 2% of GDP in 1972 (*vs* 13 2% in 1961) This production was concentrated on the finishing ("easy) stage of manufacturing operations with low added-value The proportion of the labor force employed in manufacturing did not maintain pace with the industry's output, for the industrial productive process was capital intensive By 1971 the strategy of regional import-substituting industrialization began to show signs of diminishing returns, international terms of trade had deteriorated by 12% over the previous decade, the foreign trade surpluses of the early 1950s disappeared and Costa Rica s balance of payments accelerated

2 3 Exhaustion of the Import-substitution Model and Debt Crisis 1972-1981

By 1972 Costa Rica's population and per capita GDP were twice those of 1950 In the 1970s significant external (mostly oil) shocks took place and the terms of trade of most oil importing countries deteriorated However, in the case of Costa Rica important increases in the international price of coffee compensated, during the middle of the 1970s, for the higher oil prices External commercial financing became abundant with the recycling of oil dollars by OPEC members Costa Rica took "advantage" of this and instead of *adjusting* internal absorption to a deteriorated external environment, chose to *finance* its external deficit Public sector external debt grew from 58% of GDP in 1970 to 179% in 1989 (Vargas T 1990)

Central government had grown considerably By 1980 revenues had increased to 20% of GAP (from 13% in 1973) The decentralized public sector (conformed by autonomous institutions and SOEs) had become as large as the central government Labor force had doubled from 1950, but while private sector employment increased 1 8 times since 1950, that of the public sector increased 4 9 times Public sector employees represented 15% of the labor force and their unions became important pressure groups which rendered difficult the balancing of public sector finances in times of adverse external shocks This led to inefficiency when resources became scarce, the bureaucracy was protected at the expense of the theoretical beneficiaries of their activities

In 1972 the Costa Rican Development Corporation (CODESA) was created under corporate law to promote investment in high-risk, capital-intensive projects It was given direct access to Central Bank credit and was not constrained by most of the formalities which apply to public institutions CODESA's activities grew very fast and demanded increasing shares of the banking system's credit Its operations were unprofitable and the pressures to close it became unbearable

During this period the authorities did not assign to the exchange rate its real function Thus, in spite of minor nominal devaluations of the Costa Rican Colon *vis-a-vis* the US Dollar in the early 1960s and mid 1970s, the exchange rate policy *systematically* favored overvaluation of the Costa Rican currency In the second half of the 1970s the real effective rate (which takes into consideration the domestic price index and that of the US, Costa Rica s main trading partner) deteriorated almost 20% (World Bank, 1980, p 88) and this favored imports at the expense of exports The *dirigist* credit policy carried similar problems real interest rates remained negative for some of the years during the 1970s and credit, which was targeted to a great extent, was heavily concentrated in powerful, influential groups

In the early 1970s the government introduced the Certificado de Abono Tributario (CAT) to compensate for the anti-export bias, generated by the prevailing rules, and to encourage exports of non-traditional goods to extra-CACM countries The CAT consisted of a negotiable tax credit for up to 15% of the f o b export value The use of CAT grew dramatically from less that US$0 5 million in 1973-74 to about US$10 million in 1977-78 CATs also prove difficult to manage and the fiscal impact of them became unbearable in the early 1990s--when their concession was eliminated

In the late 1970s several adverse external circumstances affected Costa Rica s economy coffee prices dropped to their usual level, the demand for exports declined with the world recession international interest rates (e g, Prime Libor) skyrocketed, the political (and economic) climate in most Central American countries deteriorated, exports to the area disaccelerated and both domestic and foreign investment, and lending, declined In such circumstances the sustained fiscal disbalances, and the excessive absorption of the economy turned into the most severe economic crisis of the last 50 years

The Carazo Administration (1978-1982) instead of adjusting the internal demand to the prevailing circumstances chose to finance the external disequilibrium, while external credit was still available Public sector external debt relative to GDP almost tripled from 1978 to 1981 when the country suspended external debt payments The public sector turned to internal financing, which crowded out private investment, production stagnated and unemployment doubled to reach for the first time in many years worrisome levels The consumer price index increased 65% in 1981 and 90% in 1982--unprecedented levels by

Costa Rican standards The exchange rate deteriorated and multiple rates and exchange controls followed

2 4 The Beginning of Structural Adjustment 1982-1994

The forces that brought the economic crisis of the early 1980s were of a structural, not conjunctural, nature The temporary increase of oil prices and the rise in international interest rates which took place in the late 1970s merely accelerated the crisis, but hardly caused it The exhaustion of the import-substitution model and the structural fiscal disbalances, which can be corrected with domestic policies, were to blame for most of the crisis

In the late 1970s the need to modify the basic economic rules (i e , model) was already highlighted by multilateral institutions (see The World Bank, 1980) and local think tanks (c f ANFE 1979) However, those recommendations were ignored by the Carazo Administration on the grounds that the socio-political problems that were experiencing other countries, particularly Nicaragua, could infest Costa Rica if the government abruptly changed the rules of the economic game

In 1982 Luis Alberto Monge, from PLN, was elected President of Costa Rica with an ample majority of the votes The solution of the economic problems became a priority of his agenda In spite of his social-democratic, interventionist, formation, Monge favored the adoption of structural reforms Those reforms aimed at stabilization (and were included in a stand-by agreement with the IMF) as well as structural adjustment The measures included in the structural adjustment program (which was used to support a loan from the World Bank) had to do with tariff reduction, control of public sector expenditure elimination of certain subsidies, adoption of realist interest and exchange rates, privatization and others Monge s reforms were backed by significant capital inflows, from multilateral institutions as well as from USAID This influx contributed to reduce the (social) pain that the necessary strong adjustment would otherwise have implied

The following administrations (i e , Arias, Calderon and Figueres) continued the structural reforms initiated in the early 1980s and extended them to the financial sector, safety net export promotion and sustainable growth

3 The Nature of USAID s Assistance to Costa Rica 1946-1994

USAID s financial and technical assistance to Costa Rica has pursued different objectives during the different stages of economic development of the country For the purpose of this study USAID's cooperation will be divided into four different periods

1946-1961 Technical Assistance
1962-1972 High Development
1973-1981 Alleviation of Poverty and Basic Needs
1982-1994 Stabilization and Structural Transformation

USAID s financial assistance to Costa Rica started in 1952 From that year to 1961 the assistance amounted to about US$21 millions, of which half consisted of donations and the rest were soft loans During that period USAID and IBRD (World

Bank) were the two major providers of external funds to Costa Rica USAID funding was directed to the financing of specific projects, specially in physical infrastructure which not only was very much needed by Costa Rica but also had a strategic military interest for the United States The construction of the Costa Rican Interamerican Highway the Juan Santamaria International Airport and the improvement of the services rendered by the Pacific Railway are examples of this collaboration Aid was also directed to agricultural extension services and sanitation programs, aimed at eradicating certain deceases

With the creation of the Alliance for Progress, in late 1961, the Kennedy Administration assigned great importance to Latin America During the ten years that comprise the period known as High Development, USAID s assistance (part of which consisted of grants) increased to some 16% of Costa Rica's export revenue The general nature of this assistance was similar to the one during the first period USAID s funding continued to be significant but began to loose importance to that supplied by the World Bank and the International Development Bank (IDB)

From 1973 to 1981 the amount of financing (including grants) supplied by USAID to Costa Rica decreased significantly--to no more than ten percent of total external inflow, and much less than that in terms of Costa Rica's export revenue IDB and the World Bank became, in that order, the main suppliers of external funds to Costa Rica USAID and multilateral financing and grants were directed to projects considered priority by the country and by the respective agencies They were not very much concerned with conditioning their assistance to the adoption of structural reforms by Costa Rica

Public sector debt with commercial banks became an important (and dangerous) source of foreign exchange during this period In the late 1970s, USAID was seriously considering the possibility of facing out its activities in Costa Rica However, the emergency of the economic crisis of the early 1980s changed USAID s perceptions

'By 1981, [Costa Rica s] foreign exchange reserves were exhausted, and the attempt to maintain real income collapsed Per capita GDP declined by 16% from 1980 to 1983 Inflation exceeded 100% by mid-1982 Real wages plummeted in 1981 and 1982 even after some recovery in 1983, they were only 79% of the 1980 level By 1982, unemployment and underemployment rates had doubled to 9% and 14% respectively (USAID 1988 p 2)

This situation, along with geopolitical considerations regarding the troubled neighboring Nicaragua, whose instability could contaminate Costa Rica if its economic conditions were allowed to deteriorate, prompted USAID to reactivate its financial activity in Costa Rica

Another factor which explains the renewed interest that USAID showed in Costa Rica was the recommendation made by the National Bipartisan Commission on Central America (NBCCA or Kissinger Commission) In early 1984 the NBCCA proposed expanded economic assistance to the democratic countries of the region in order to

1 Arrest economic decline and promote *stabilization*
2 Promote sustained economic growth through *structural transformation*
3 Increase equity and spread the benefits of growth, and
4 Strengthen *democratic institutions* and processes

The above objectives were adopted by USAID in Costa Rica (c f , USAID-COSTA RICA, 1990, p 4) and significant amounts of external resources, mostly as grants for balance of payments support, were brought into the country as from 1983 The aid levels averaged US$163 million per year from 1983 to 1988 USAID's first step was to help control the deterioration of economic variables through the injection of sizable amounts of hard currency to support balance of payments requirements By so doing the volume of imports should not have to fall abruptly, lowering the possibilities of reactivating the productive capacity of the country, and the exchange rate did not need to increase much

The summary descriptions of the grants given to the Government of Costa Rica in general read like the following text, which is taken from USAID's Program Assistance Approval Document (PAAD), project 515-0222, dated June 2, 1986

> 'The purposes of the [Economic Support Funds-EFS] are to provide *balance of payments support* to A I D stabilization efforts in Costa Rica, to encourage policy and structural changes aimed at re-establishing dynamic growth in the economy through increased exports The [US$xxx] grant which will be signed with the Government of Costa Rica will consist of a cash transfer to the Central Bank of Costa Rica, the dollar equivalent of which will be made available for sale to private producers Imports from the U S of raw materials, intermediate goods, construction material, capital equipment and spare parts in an amount at least equal to the grant will be required An amount in *local currency* equivalent to the grant will de deposited by the Central Bank in [a] Special Account Disbursements of local currency from the account will be made pursuant to implementation letters for the *mutually agreed-upon development purposes* specified in the PAAD ' (*Italics* added)

These grants for "balance of payments support' provided dollars which the Central Bank would sell to local entrepreneurs, to pay for imports they needed from the U S Each time the Central Bank received a new infusion of US Dollars, an equivalent amount of local currency (Colones) was deposited in a Special Account The colones of this account were owned by the government of Costa Rica (GoCR) and allocated for development purposes by joint agreement of USAID and GoCR

During the above-mentioned period of "Stabilization and Structural Transformation' the four objectives underlined by the NBCCA were pursued by USAID-CR with direct allocations of support funds, as follows

3 1 First target Economic stabilization

Between 1982 and 1989 USAID made available to Costa Rica US$1072 millions in Economic Support Funds (EFS) A considerable part of those funds were donated to the Central Bank to help it reduce its losses Also, other funds were assigned to service CODESA s obligations with the Central Bank Those two allocations (which were in excess of CRCols 20 000 million--or 7% of the average GDP during the period) were by far the largest ones and were not accompanied by local currency requirements--the purpose behind them was to help the stabilization efforts of the GoCR

In order to maintain a reasonable level of credit for the private sector during the period of economic adjustment, several "credit lines" were opened within the Central Bank, and channeled through public and private banks, with funds supplied by USAID The amounts involved were significant as well

3 2 Second target Promotion of sustained growth through structural adjustment

Local currency fund were made available for the creation of Coalision Costarricense de Iniciativas para el Desarrollo (CINDE), a non profit private organization dedicated to promote economic growth CINDE is engaged in export promotion FUNDEX, which undertakes export-oriented activities, also received funding from ESF local currency component

Funds were also assigned to help the GoCR carry the public sector reform program To this end sizable amounts were assigned to the 'labor mobility program which helped pay severance to public servants that accepted transference to the private sector Financing to the public sector reform program, as well as to Ministry of Exports (MINEX) to support export and investment promotion efforts, fall in this category Different projects in the areas of energy, natural resources, financial system reform, free zones and roads were also financed by USAID grants

3 3 Third target Increase equity and spread the benefits of growth

Under this category, the largest contribution (some 3% of GDP) went to finance the establishing of Escuela Agricola de la Region Tropical Humeda (EARTH), which is engaged in teaching agriculture at the undergraduate level with the method "learning by doing The students that attend EARTH come from all Central American countries

Banco Hipotecario de la Vivienda (BANHVI) received significant funding from USAID to strengthen the financing of low housing (and mortgage discount) through public and private entities Funds were also made available to improving the quality of general elementary education (through the publication of books, support of computer literacy programs and remodeling of public schools)

Funds were made available to Caja del Seguro Social (CCSS) to import medicines, to ACORDE to lend to NGOs that finance microenterprise, to family planning programs and self-help community projects as well as rural development Foundations dedicated to the preservation of the environment (e g , Fundacion Parques Nacionales, Foresta and Neotropica) also benefited from USAID funding

3 4 <u>Fourth target Strengthen democratic institutions and processes</u>

Since Costa Rica is one of the most vibrant democracies of the developing world, USAID s actions to promote democracy have been limited However, local currency ES funds were used to finance scholarship programs (at undergraduate and graduate level as well as short-term studies) abroad that benefited many Costa Ricans, to help raise the professional quality of institutions that operate in the area of Justice (such as Instituto Latinoamericano de Prevencion del Delito, ILANUD, and the Interamerican Institute of Human Rights) and to strengthen the cooperative movement in Costa Rica

Private universities and other learning institutes (e g , UACA, INCAE, CIAPA) received funds to finance the publication of books on classic democratic topics, that were to be sold to the public at subsidized prices and to conduct activities which helped the investment climate and the democratic system

3 5 <u>General Conditionality</u>

Aid during this period of Stabilization and Structural Transformation was heavily *conditioned* to the adoption of structural reforms In this sense it differs significantly from previous grants and soft loans, which took the *status quo* and the authorities policy choices as given The conditionality of USAID's financing was crossed with that of multilateral agencies, mostly IMF, World Bank and IDB

USAID and other donors were by then fully aware that Costa Rica could not depend on traditional exports only, and that non-traditional exports to non-CACM countries should be encouraged USAID conditioned its grants to the adoption of policies that

(a) help modernize the financial system,
(b) allowed realistic interest rates to operate,
(c) assign the foreign exchange its market value,
(d) promote the liberalization of the economy (through tariff dismantling and internal price decontrol),
(e) aim at reforming (i e , modernizing) the public sector, including privatization of SOEs, improve the distribution of benefits of economic progress among the different members of society, and
(f) help achieve sustainable macroeconomic stability

Part of USAID economic support facilities (ESF) was used to induce specific reforms in the financial sector, aimed at the above objectives and at strengthening private banking in the country (by for example, given them access to short term deposits and to the rediscount from the Central Bank) Funds were conditioned to the compliance of the country with deficit-reducing targets agreed upon with the IMF and with structural reforms (such as tariff reduction, export promotion, CODESA's divestiture, public sector downsizing and labor mobility targets) agreed upon with the World Bank and IDB under structural adjustment loans

4 US AID Impact on Costa Rica's Development Over the Last Fifty Years

It is very difficult, if not impossible, to assess the impact of a single variable (in this case US AID technical and, specially, financial assistance) upon the growth pattern of a country over a long period of time The first reason for this is that the exercise should compare the (actual) case "with USAID" with the (theoretical) situation "without USAID The latter would probably not be one case but a set of possible scenarios The second reason is that growth is conditioned by many variables and it is hard to single out the effect attributable to any one of them In spite of the above limitation, the author of this portion of the study considers that the following conclusions are reasonably valid regarding the impact of US AID on Costa Rica s development over the last 50 years

The first conclusion from the study is that the role of US AID in Costa Rica has to be divided into two periods pre-debt crisis and post-debt crisis The first covers the period 1946 to 1982 and the second 1982 to present During the first period US AID collaboration with Costa Rica was based on the idea of *projects*, such as the construction of highways, airports decease and poverty fighting and agricultural extension Said Joe Sconce, US AID-Costa Rica Mission Director 1974-1977, when interviewed in July 1995 by Mr I M Fox ' AID spent little effort on macroeconomic concerns during this period Its focus as that of AID-Washington, was on poverty" Mary Kilgour, Program Officer, 1978-1981 recalls that "There was no mission economist, and little attention was given to macroeconomic issues or policymaking"

Information regarding USAID s activities during the first period, prior to the debt crisis is the subject of analysis by experts in the respective areas (e g , agriculture, health, infrastructure) which is presented in other sections of this study Those activities were strongly focused on infrastructural projects --such as the construction of Costa Rica s portion of the Interamerican Highway and the Juan Santamaria International Airport-- which, besides helping the country, had a geopolitical interest for the US during the peak of the Pacific War Being an agency of the US government, USAID s priorities somehow have to conform the political and economic philosophy of the different US administrations Thus, for instance during the early sixties the Kennedy Administration favored an active State participation in, and direction of, the economic process and was convinced that some degree of central planning was welcome This attitude reflected in the pressure that that administration exerted over the GoCR to create a Planning Office and to join the CACM in order to benefit from its Alliance for Progress It has to be recognized, however, that those ideas were also popular in Costa Rica at the time, so they did not really constituted an imposition The joining of the CACM constituted, in the true sense of the expression, an structural change of Costa Rican economy, as explained in the previous sections

During the 1950s and 1960s Costa Rica economic and social performance could be considered successful Costa Rica was one of the few countries without a standing army which allowed it to allocate large sums to public education and health, which were instrumental in producing over time a reservoir of skilled manpower and an institutional framework that in many respects was comparable to more developed countries The public sector played a major role in this respect Indirectly it provided generous incentives and basic economic infraestructura to stimulate private sector growth, and by satisfaying a rapidly growing demand for social services, it contributed to a widespread increase in economic opportunities and a better distribution of development benefits More directly, the growing importance of the public sector expenditure helped the economy maintain a satisfactory growth rate in spite of falls in private sector activity This was, precisely, what most Latin American countries aimed at when they subscribed The Charter of Punta del Este

To this end, the participation of USAID in project financing was in line not only with local policymakers conceptions, but also with the modal international approach to development through State planning However, the country's investment and growth achievements were soon accompanied by substantial internal and external instability (as if there is no free lunch) which contributed to the crisis of the late 1970s and early 1980s

During the second period (1982 to present) the emphasis of USAID financing and counseling to the GoCR was on (*structural*) *reforms* that could promise sustained development Again, in this sense USAID's approach was not different from that of multilateral financial agencies such as IDB and the World Bank

In Costa Rica the expression *structural reform* is ordinarily reserved for the policies and measures aimed at downsizing the public sector and liberalizing the economy These reforms started after the debt crisis Even though Costa Rican think tanks, such as ANFE have favored structural reforms in the sense they are understood today since the mid-1970s the main proponents of those ideas where multilateral agencies such as the World Bank IDB and the IMF USAID missions in Costa Rica did not show particular interest in inducing structural reforms before 1980 Thus, for instance, in 1973 USAID s Development and Assistance Program for Costa Rica even when based on a good diagnosis of the problems that were in the making, contained the following "Areas of AID Emphasis A Agriculture, B Population, Health & Nutrition and C Sub-Regional Development

In like manner, the "Country Development Strategy Statement FY 1981 , prepared in 1979, states that "The purpose of [USAID's] assistance to Costa Rica is to support the GOCR s commitment and serious efforts to achieve equitable development which will bring lasting improvement to the lives of Costa Rica s poorest citizens Those objectives were hardly attained --on the contrary, the country's worst economic crisis of the last 50 years took place during that period-- because the government s plans were not based on an adequate diagnosis of the situation Before 1980 the official economic decisions were based on insufficiente information because the government did not even operate with a consolidated public sector budget However, USAID s 'Country Development Strategy Statement FY 1984 prepared in January, 1982, based on a good analysis of the underlying situation recognized that "The prospects for continued improvement in the

GOCR s fiscal accounts so far during 1982 are not good The incumbent government shows little, if any, intention of exercising fiscal and monetary control for the remainder of its terms in office, which end in May of 1982" Based on that, USAID's Mission in Costa Rica realized that it should not take the status quo and the official policies as given, rather, it considered that 'Costa Rica's present crisis cannot be regarded as just a temporary aberration or another cyclical downturn in its economy, and its impact is not confined to the purely macro-economic sphere" Thus, USAID assistance was conditioned to the adoption of reforms aimed at stabilizing the economy and at promoting sustained growth

USAID also considered that there were geopolitical reasons (e g , preservation of Costa Rica s democratic practices in the face of a troubled Nicaragua) which justified, in the early 1980s, a massive injection of foreign aid In this sense, USAID's perception was right for the severity of an stabilization program coupled with scarcity of foreign exchange would have been *very* difficult

Table 1
USAID Assistance to Costa Rica *
(Commitments in millions of Current US dollars)

Period	Amount	Average	% of total**
1950-1960	11 4	1 0	42 7%
1961-1972	99 1	8 3	44 1
1973-1981	72 2	8 0	9 8
1982-1989	1072 7	134 1	30 1
1990-1993	153 4	38 4	34 0
Total US $	1409 1		

* Source Muench, S , 1995 Table 9
** Simple average The agencies included are USAID, IBRD, IDB, IFC and UN

Most of the policy reforms backed by USAID, and included in the general conditionality (see 3 5 above), achieved their general purposes Thus, for instance, Costa Rica s financial system was gradually modernized with specific regulations adopted by the Central Bank and with resolutions of the Constitutional Court (Sala IV) during the late 1980s and early 1990s and with important legal reforms ennacted by the Legislative Assembly in 1994-95 The trade regime was opened by both reducing external tariffs and by internal price decontrol CODESA's divestiture was carried out as programmed but no further privatizations were undertaken However, the idea of selling state entreprises in order to raise funds to reduce internal debt has been increasingly backed by outstanding members of the main political parties

As far as the objetives of achieving sustainable macroeconomic stability and public sector reform are concerned the results have been mixed The different administrations have shown signs of fiscal restraint at the beginning of their terms and fiscal expansion (and deficits) in preelectoral years Thus, even when the public sector employment relative to the total employment has decreased somewhat from 1980 to the present, the ratio of non-financial public sector expenditure to GDP has not been reduced

As shown in Table 1, USAID financial assistance to Costa Rica during the period 1982-1989 was by far the largest of the 50-yr period analyzed It is a fact that any external financing (specially grants) reduce the urgency of adjustment However, the funds that USAID made available to Costa Rica during the early and mid-1980s helped reduce the cost of the adjustment *without* changing its direction In other words, the influx of grant funds was meaningful but not sufficient to fully compensate for the prevailing foreign exchange shortage Thus, as shown in Table 2, Costa Rica s imports for the years following the emergence of the crisis were reduced significantly and, given the country s high dependence on imported inputs, exports decreased as well The trade balance improved but the current account continued to be negative in spite of the accelerated depreciation of the Costa Rica's Colon vis-a-vis the US dollar

Table 2
Costa Rica's Post-Crisis Current Account Position
(In millions of current US dollars)

Year	Merchandise Exports	Imports	Trade Bal	Current Acc
1981	1003	1091	-88	-409
1982	869	805	64	-297
1983	853	898	-45	-283
1984	998	996	0 8	-155
1985	939	1005	-66	-130
1986	1085	1049	36	-80
1987	1107	1245	-138	-257
1988	1181	1279	-98	-178
1989	1333	1572	-238	-415

Source Vargas, T R y O Saenz, 1994, Table SX-1

Without that assistance, the exchange rate would have had to increase many times more than it did in order to balance absorption with external financing possibilities Imports (and investment) would have decreased more than shown in Table 2 and so employment and general welfare The social dislocations that this would have produced would have been significant However, as documented by Cespedes V H and R Jimenez (1990, p 143-4) "The economic indicators of family welfare revealed a deterioration during the economic crisis and an improvement afterwards Thus, during 1981 and 1982 there was a general deterioration of the purchasing power of the population Real salaries improved after the crisis in such a way that by 1989 they have recuperated their 1980 levels With the economic recovery the wage earners increased their incomes faster than the growth of the country s per capita income"

It should be mentioned, however, that *strictu sensu* balance-of-payments support should have *not* been accompanied by "local currency' development financing, because this creates *new* expenditures, which increase absorption, while the idea of balance-of-payments support is to finance a *given* level of absorption The local currency component in a way, also implied some kind of expense *dirigisme* and, more importantly, contributed to an undue expansion of the money supply In this sense, a technical report (Belt, J A, 1992, p 2) indicates that "even though there has been a fairly restrictive fiscal stance" on the part of the Calderon Administration

> "Expansion of the monetary base (currency issue plus commercial bank deposits at the Central Bank) during the past three years has resulted largely from reserve increases, Central Bank losses, and monetization associated with AID programs Monetization associated with AID programs has been the equivalent of about 50 percent of the excess expansion of the monetary base during the period 1989-91, and therefore a large proportion of the inflation of the past three years has been caused by AID"

This led Mr Belt to consider that the "elimination of monetization associated with AID programs should be the highest priority of the USAID/CR Mission"--a recommendation that the author in principle endorses

Irrespective of how noble they were, the development projects financed with the local currency counterpart, even when "mutually agreed-upon" by GoCR and USAID, were subject to pressures from influential groups (e g , CIAPA, INCAE, UACA, CINDE) The funds dedicated to finance low-cost housing during the Arias Administration helped it fulfill campaign promises on this respect Public roads and schools improved with USAID local currency financing constitute similar examples--and, in a way, constituted public sector expenses that did not carry the approval of the Legislative Assembly This led some people to criticize the "parallel State' that USAID local currency financing helped create However it could be also argued that *un*conditional supply of grant funds could have easily tempted the incumbent administrations to incur new expenditures, to serve short-term (myopic?) political interest and not necessarily to finance (long term) structural reforms Joint USAID-GoCR local currency programming could have reduced such risk

Credit to exporters under USAID's credit lines was to a great extent given at below-market rates and this opposed the general direction of the reforms Also, some of the purposes financed by USAID under the local currency component induced rent-seeking behavior to the extent that the working conditions in and, especially, remuneration levels of, the respective non-profit organizations that they served were above average To the extent that the services rendered by the organizations created by USAID were free for their final clienteles, in some cases this made them supply- and not demand-driven The scholarship program, although not too expensive in dollar terms, rendered ample benefits to the country because its beneficiaries presently occupy important policy-making positions and or are respected opinion makers (There seemed to be a little bias in the concession of scholarships to sons of already influential Costa Ricans, and not to the members of grass roots communities) The recommendation on this respect is to try to use more competitive means for the allocation of funds under local currency development projects and give end-users more saying in the kind of services rendered

The above circumstances, however, constitute *pecata minutia* when compared with the enormous benefits that USAID grants to the GoCR brought during a period when foreign exchange was so necessary for the country to maintain its purchasing power and dynamism Without USAID's help the structural adjustment process would not have been as smooth as it turned out and the cost of the economic adjustment would have been higher--perhaps unbearable

In summary, as far as the *conditioning* is concerned, it is the author's opinion that even though it was not necessarily an USAID's original idea, because in many respects it coincides with that established by leading multilateral agencies, such as the World Bank IBD and IMF, it was adequate, well-meant and proper, for grants without the right conditioning (just like the easy external commercial loans available during the 1970s) only serve to finance the disequilibrium On the contrary, grants conditioned to the adoption of the reforms that lead to sustained and shared growth, reduce the cost of the adjustment process

USAID and multilateral institutions collaborated effectively with Costa Rican economic authorities (which, in general, after the crisis favored market-oriented reforms) and cross-conditionality was properly agreed among them USAID-CR in general managed the linkage between conditions and disbursements appropiately

The above leads the author to believe that USAID impact on Costa Rica's development during the last fifty years was very positive

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Author's Biography

Thelmo VARGAS MADRIGAL, Costa Rican citizen, holds a B A in Economics from Universidad de Costa Rica, an MBA from the University of California at Berkeley and a Diploma in Non-life Insurance from the College of Insurance, Surbiton, Surrey
Mr Vargas has been Provost of National University in Costa Rica, President of ANFE and UACA
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Mr Vargas has been member of the Board of Directors of the Central Bank of Costa Rica and Minister of Finance of Costa Rica Presently he as researcher at Academia de Centroamerica

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